

# California State Controller's Review of the Proposed San Fernando Valley Special Reorganization Comprehensive Fiscal Analysis



State Controller  
Kathleen Connell



**KATHLEEN CONNELL**  
**Controller of the State of California**

April 1, 2002

Mr. Larry J. Calemine  
Executive Officer  
Local Agency Formation Commission  
for Los Angeles County  
700 North Central Avenue, Suite 350  
Glendale, CA 91203

Dear Mr. Calemine:

The State Controller's Office has completed a review of the questions raised by the City of Los Angeles regarding the Comprehensive Fiscal Analysis prepared by your Commission for the Proposed Special Reorganization of the San Fernando Valley. A report of the review and findings is enclosed.

My audit staff is available to consult with you on the details of our review and findings, at your request.

Sincerely,

A handwritten signature in black ink, which appears to read "Kathleen Connell". The signature is fluid and cursive.

KATHLEEN CONNELL  
State Controller

**CALIFORNIA STATE CONTROLLER'S REVIEW  
OF THE PROPOSED SAN FERNANDO VALLEY  
SPECIAL REORGANIZATION  
COMPREHENSIVE FISCAL ANALYSIS**



**KATHLEEN CONNELL**  
California State Controller

April 2002

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## **Executive Summary**

### **Background**

A proposal was presented to the Los Angeles County Local Agency Formation Commission (LAFCO) for the special reorganization of the San Fernando Valley area of the City of Los Angeles (City). A special reorganization includes the detachment of territory from a city or city and county and the incorporation of that entire detached territory as a city.

The executive officer of LAFCO prepared a comprehensive fiscal analysis (CFA) for the proposed incorporation in accordance with the requirements of *Government Code* Section 56800. The CFA was published on January 9, 2002. Subsequently, on February 21, 2002, LAFCO released a supplemental report to the CFA.

*Government Code* Section 56801 allows any interested party to ask LAFCO to request that the State Controller's Office review specified elements of the CFA with regards to the accuracy and reliability of the information, methodologies, and documentation used in the analysis. Within 45 days of receiving a request, the Controller is required to issue a report to the executive officer of LAFCO.

On February 11, 2002, the City submitted a request to LAFCO that the State Controller's Office review five issues. The State Controller's Office received the request on February 14, 2002. The five issues are:

- 1— Does the CFA provide for a sufficient level of reserves for the reasonable operation of the proposed new city?
- 2— Does the CFA adequately analyze whether the remaining City of Los Angeles will be subjected to financial harm?
- 3— Does the CFA adequately address the fiscal impact of the proposal on other affected agencies?
- 4— Does the CFA establish an accurate service level for the proposed new city: (a) equal to the current level; and (b) based upon a base-year budget of the City of Los Angeles?

- 5— Did the CFA's calculation of revenue neutrality reflect the cost impacts the City will realize at the end of the transition or service contract period?

To the extent necessary, this analysis of these issues incorporates the information included in the supplemental report to the CFA.

## **Findings**

- 1— The State Controller's Office has determined that there is no authoritative basis for determining a "sufficient" level of reserves. However, the projected general fund reserves for the proposed new Valley city of 0.4% to 1.3% are significantly below those of comparable-sized cities in California; those cities maintain general fund reserves of 4% to 4.8%.

In addition, several cost items in the CFA were understated, particularly for bond debt; this could virtually eliminate any general fund reserves.

Moreover, future year reserves for the proposed new Valley city are contingent on many unknown financial variables. The State Controller's Office research indicates that reserve levels tend to fluctuate from year to year. Therefore, the portion of the CFA that indicates the reserves for the new Valley city will increase is unreliable.

- 2— The State Controller's Office concludes that the CFA adequately considers the financial impact to the remaining City. However, the review also identified a potential adverse effect on the projected reserve level for the new Valley city, resulting from a change in the bonded debt allocation ratio.
- 3— The State Controller's Office concludes that the CFA did not address all fiscal impacts of the proposed new Valley city on affected agencies other than the City of Los Angeles. However, in some cases it was not required to do so, and in other instances no mitigation was required.
- 4— The State Controller's Office has concluded that the methodology used in the CFA to allocate service level is reasonable and accurate. The costs for direct and indirect services are based primarily upon the approved positions on the City's organization charts, reconciled to the approved positions in the City's budget.

- 5– The State Controller’s Office concludes that the City of Los Angeles has accurately described how revenue neutrality was addressed in the CFA and that mitigation does not include stranded costs.

## REVIEW FINDINGS

**CITY ISSUE 1** The City raised the following issue in its request to LAFCO:

**“Does the CFA provide for a sufficient level of reserves for the reasonable operation of the proposed new city?”**

The City noted a number of adverse fiscal impacts that may result if the level of reserves is not sufficient for the operation of the new Valley city. Specifically, the City states:

The City believes that the projected reserve levels are insufficient and that the following fiscal impacts are likely:

- a. A decrease in services beyond the level stated in the CFA.
- b. An increase in taxes or fees in the new city after incorporation.
- c. An increased risk to the remaining City of Los Angeles budget, as the new city may default on payments to the City (e.g., debt, service contracts, mitigation payments) and thereby potentially cause massive adverse service level impacts to the remaining City. This concern has been raised by Moody’s Investor Service and should be factored into the findings of the CFA.

The City identified seven concerns to support its position that the CFA did not provide for a sufficient level of reserves for the reasonable operation of the proposed new city. These concerns are:

**City Concern 1:** The level of projected reserves for the new Valley city should be higher.

**City Concern 2:** The revenues and expenditures are incorrectly computed.

**City Concern 3:** The initial complement of 19 employees is insufficient to sustain current service levels.

**City Concern 4:** The CFA contains inaccurate costs for an election, contract administration, and transition activities.

**City Concern 5:** The CFA has misstated the impact of the documentary transfer tax.

**City Concern 6:** The CFA fails to account for start-up costs.

**City Concern 7:** The CFA fails to account for the exclusion of the Cahuenga Pass area from the new Valley city.

### **ANALYSIS OF UNDERLYING CONCERNS CITED BY THE CITY AS ITS BASIS FOR CITY ISSUE 1**

#### **City Concern 1**

The City notes the positive reserve level in the CFA but states that sound financial management requires that the reserve level be much higher. The City states that the CFA assumes a level of fiscal stability for the new Valley city greater than the existing City. Specifically, the City states:

The CFA adopts a structural reserve level of approximately 0.7% and assumes accumulation of all reserves over a three-year period to achieve a reserve level of approximately 2%. CFA at 12; App I at 12. Sound financial management requires a reserve considerably higher than 0.7%. Unforeseen circumstances, such as payouts required by litigation, call for a sufficient reserve. The CFA has assumed a level of fiscal stability in the proposed new city greater than in the existing City of Los Angeles without having a basis for doing so.

#### **State Controller's Office Analysis and Response to City**

**Concern 1:** The State Controller's Office has determined that no authoritative basis exists upon which a "sufficient" level of reserve can be determined.

The State Controller's Office reviewed the level of reserves from the *Cities Annual Report* filed with the State Controller's Office for fiscal year 1998-99 for cities with a population greater than 1,000,000 and found that the cumulative level of general fund balances, unreserved and undesignated, as a percentage of

general revenues, ranges from 4% to 4.8%. This is considerably above the 0.4% to 1.3% for general fund reserves included in the CFA for the proposed new Valley city.

Moreover, future year reserves for the proposed new Valley city are contingent on many unknown financial variables. The State Controller's Office research indicates that reserve levels tend to fluctuate from year to year. Therefore, the portion of the CFA that indicates that the reserves for the new Valley city will increase is unreliable.

The State Controller's Office notes elsewhere in this report that some of the cost calculations in the CFA were inaccurate (see ISSUE 2, City Concern 4) and could virtually eliminate the projected general fund reserves.

## **City Concern 2**

The City expressed its second concern as follows:

The CFA appears to assume revenue growth equal to expenditure growth. Fiscal year 2002-2003 is expected to experience declining revenues. Certain costs – such as employee compensation, costs of goods and services, postage, leases, petroleum, and electricity – are projected to increase in 2002-2003. Consider, for example, current labor contracts (“memoranda of understanding” or “MOUs”) that call for salary increases. See MOUs enclosed. Under Cortese-Knox, those labor contracts must be honored. Hence, the apparent assumption appears to be flawed. CFA at 12-35; App I at 4; App III.

## **State Controller's Office Analysis and Response to City**

**Concern 2:** The State Controller's Office concludes that the use of constant dollars to determine revenues and expenditures is an appropriate methodology for two reasons.

First, there is no evidence that the financial variables cited by the City will fall disproportionately on any geographic area within the current boundaries of the City of Los Angeles. If the fiscal stress caused by these variable results in lower service levels or reduced fiscal viability, it will do so regardless of whether the special reorganization occurs. This is because it is assumed that the City had a plan to absorb the increased costs through increased

revenues or cost reductions. Since there is no evidence that these costs will impact the new city in any disproportionate manner, the same actions can be taken by the new Valley city.

Second, the CFA was published on January 9, 2002, only weeks after the employee MOU negotiations were concluded. While this item alone will increase total costs to the City by \$570 million over a three-year period, a large city such as Los Angeles is likely to have such changes occurring frequently and it would be difficult to capture the potential impact of all changes as they occur once the CFA has been published.

### **City Concern 3**

The City expressed its third concern as follows:

In providing a complement of 19 employees to administer essential municipal functions and ensure compliance with service contracts with the City of Los Angeles, the CFA has provided a staffing level insufficient to sustain current service levels in the proposed new Valley city. See CFA at 15-16, 19; App I at 7.

### **State Controller's Office Analysis and Response to City**

**Concern 3:** The State Controller's Office concludes that the methodology used to develop the proposed staffing level is reliable. The State Controller's Office also determined that if the new Valley city needs to fund additional staff positions, there are discretionary revenues available. However, if discretionary revenues are used for this purpose, the result will be a decrease in available reserves.

While the City states that 19 initial employees are insufficient, it provided no suggested staffing level.

The State Controller's Office determined that the primary CFA data sources used to develop the estimated staffing level were budget documents of California cities that incorporated since 1997. While the new Valley city differs from other recent incorporations in several ways (the large size, a detachment from another city, etc.), it also shares common characteristics with other newly incorporated cities, including:

- Limited revenues allow a new city to afford only a minimum initial staff; and,
- The new city would contract with other agencies, particularly the City, for the delivery of essential services. This will reduce the need for additional new Valley city employees.

#### **City Concern 4**

The City expressed its fourth concern as follows:

The CFA contains inaccurate election and contract administration costs and does not appear to account for the repayment of all City transition costs (costs incurred by the City as a result of the special reorganization). CFA App. I at 11-12.

#### **State Controller's Office Analysis and Response to City**

**Concern 4:** The State Controller's Office determined that the CFA has understated election, contracts administration, and transition costs by \$1,240,300. However, the State Controller's Office also determined that the CFA contains \$500,000 in excess funding for redistricting costs that can be used to partially address these costs.

**Election Costs:** The State Controller's Office determined that the CFA estimate of incremental election costs of \$200,000 was inaccurate and should be increased to \$273,800. The State Controller's Office concludes that this difference, which is less than one-hundredth of 1% of the new Valley city's annual expenditures, by itself has an immaterial impact on the CFA.

**Contract Administration:** The State Controller's Office determined that the City's estimate of annual contract administration costs of 0.3% is more accurate than the CFA's estimate of 0.2%. While the percentage is relatively small, it represents \$1.1 million in additional cost that the new Valley city will have to absorb and which would reduce the level of general fund reserves.

The City provided a schedule, that concludes that the CFA has understated the annual contract administration costs by approximately \$1.1 million. The City has identified 14 departments, with an estimated annual contract administration cost of \$3.1 million, or approximately 0.3% of the estimated service contract cost. The City was able to provide memos from the departments to

substantiate the schedule and documentation for the memos. Therefore, the City's estimate of annual contract administration costs appears to be a more accurate estimate of costs. This item adversely impacts the projected level of reserves.

The City's one-time contract administration cost appears to be primarily an information systems issue, since 98% (\$16 million) of the one-time contract negotiation cost occurs in the Information Technology Department. The Information Technology Department manager believes that administering the contract to provide services to the new Valley city will require complex negotiations of each of 147 systems that have been defined as "critical." The department manager estimates that each negotiation will require a three-person team working four months: 147 person-years in total. The City's position is that each "critical" system application will require a separate contract.

The State Controller's Office has concluded that, while some one-time contract administration costs may be possible, the estimate of the potential costs of the Information Technology Department seems unreasonable. Many of the "critical" systems are not related to either contract administration or Valley services. For example, the list of "critical" systems includes the scheduling system in the Mayor's Office, a system for printing mailing labels, a system for tracking Savings Bond purchases, and a system that tracks property assessments for City expenses in maintaining the Wilmington Cemetery, located in the Harbor area.

Also, the City provided no justification to support why each critical system would require a separate contract or explain why each contract would require a person-year to negotiate, except to state that it was based upon past experience.

**Transition Costs:** The State Controller's Office concludes that transition costs of \$566,500 for redistricting, closing books, validation of pre-existing bonds, and establishing revenue collection procedures are appropriate. However, the State Controller's Office also determined that the CFA contains \$1 million for redistricting alone. The excess amount can fund all of these costs.

Transition costs also appear to be primarily a systems issue, since the Information Technology Department is requesting \$30 million to "assess" changes that might be required because of transitioning the provision of services from the City to the new Valley city.

However, the CFA assumes that the other agencies, primarily the City, will provide all services during the period covered by the CFA. Therefore, the transition costs discussed by the City do not need to be included in the CFA. While there will inevitably be some transition costs as the new Valley city assumes direct service provision after the period covered by the CFA, both the City and the new Valley city will need to consider those costs at that time.

### **City Concern 5**

The City expressed its fifth concern as follows:

The CFA appears to have misstated the revenue impact of the documentary transfer tax. CFA at 28. LAFCO staff indicates that general law cities, such as the proposed new city, cannot raise as much of this tax as can charter cities, such as the City of Los Angeles. A January 23, 2002, report from LAFCO staff indicated that this error in the CFA would diminish revenues by \$30.9 million and require a demonstration of fiscal viability through cost savings and/or additional revenue to achieve fiscal viability. See Report at 8-9.

### **State Controller's Office Analysis and Response to City**

**Concern 5:** The State Controller's Office concludes that the CFA overstated revenue for the amount of the documentary transfer tax by \$30.9 million to the proposed new Valley city. This will not affect the level of reserves because there will be a corresponding reduction in the mitigation payment to the City. The result is that the City will not be fully mitigated for its lost revenues. This is because *Government Code* Section 56815(b)(1) requires the determination of the mitigation payment to be based upon the revenue that will accrue to the new Valley city.

*Government Code* Section 11911 allows the board of supervisors of any county to impose a documentary transfer tax at the rate of \$0.55 for each \$500 of property value in excess of \$100. A city within a county that has imposed the documentary transfer tax may impose the tax at a rate of one-half the county amount. If the city tax is imposed at a rate of up to one-half the county rate, there is a credit against the county tax for the city tax. If the city tax is greater than one-half the county tax, no credit is granted against the county tax.

LAFCO mistakenly assumed that the new Valley city would be allowed to apply the same documentary transfer tax rate as the City of Los Angeles, which is \$2.25 per every \$500 of real property value in excess of \$100. On February 12, 2002, LAFCO issued a supplemental report to the CFA, which recognized that the new Valley city is limited by an uncoded section of the *Government Code* to imposing the documentary transfer tax at a rate of one-half of \$0.55, or \$0.275, per every \$500 of real property value in excess of \$100.

Consequently, as noted in the supplemental report to the CFA, the new Valley city will receive only \$4.3 million instead of \$35.2 million in documentary transfer tax revenue. In effect, the new Valley city's citizens will receive a tax reduction of \$30.9 million per year, while the City will lose a corresponding amount of revenue.

Finally, the County of Los Angeles will now be required to provide up to \$4.3 million to the proposed new Valley city as part of its requirement to share its documentary tax. This amount has not been included in the CFA.

### **City Concern 6**

The City expressed its sixth concern as follows:

The CFA fails sufficiently to account for start-up costs (additional costs the new city would incur as a result of the special reorganization). CFA at 12-20, 38-41; App I at 1-3.

### **State Controller's Office Analysis and Response to City**

**Concern 6:** The State Controller's Office concludes that the one-time start-up cost for the new Valley city's operations included in the CFA is accurate because the preponderance of the new Valley city's services will continue to be provided by the City during the period covered by the CFA.

### **City Concern 7**

The City expressed its seventh concern as follows:

The CFA studied a proposal for a city whose territory included the Cahuenga Pass area. On January 23, 2002, the LAFCO Commission voted to exclude this area from the territory of the proposed Valley city. As

explained more fully below, all indications are that LAFCO will be considering a dramatically different proposal than that studied in the CFA. All indications are that this new proposal will exclude the Cahuenga pass area. If LAFCO proceeds to consider a proposal so revised, a fiscal analysis for the new proposal will need to take this into account. See LAFCO Staff Report, January 2002.

**State Controller's Office Analysis and Response to City**

**Concern 7:** The State Controller's Office concludes that the CFA does not reflect the exclusion of the Cahuenga Pass area from the proposed new Valley city. However, the supplemental report to the CFA correctly addressed this change. The projected positive reserve level is not affected because the reduced revenue would be balanced by a reduced mitigation payment.

The supplemental report to the CFA, mentioned above, disclosed the fiscal impact of the Cahuenga Pass area removal. It concluded that the exclusion of the Cahuenga Pass area from the proposed new Valley city would reduce the amount of revenue that would accrue to the new Valley city by \$7.1 million (less than two-thirds of one percent), reduce the cost of purchased service by \$2.6 million (less than one-quarter of one percent), and reduce the assumed mitigation payment computed in the CFA from \$65.8 million to \$61.3 million.

The reduction in revenue and expenditure is directly offset by a reduction in the mitigation payment. Therefore, this item has no effect on the projected positive reserve level.

**State Controller's Office Conclusion Regarding City ISSUE 1:**

**The State Controller's Office has determined that there is no authoritative basis for determining a "sufficient" level of reserves. However, the projected general fund reserves for the proposed new Valley city of 0.4% to 1.3% are significantly below those of comparable-sized cities in California; those cities maintain general fund reserves of 4% to 4.8%.**

**In addition, several cost items in the CFA were understated, particularly for bond debt; this could virtually eliminate any general fund reserves.**

Moreover, future year reserves for the proposed new Valley city are contingent on many unknown financial variables. The State Controller's Office research indicates that reserve levels tend to fluctuate from year to year. Therefore, the portion of the CFA that indicates the reserves for the new Valley city will increase is unreliable.

**CITY ISSUE 2** The City raised the following issue in its request to LAFCO:

**“Does the CFA adequately analyze whether the remaining City of Los Angeles will be subjected to financial harm?”**

The City stated the following:

Cortese-Knox requires that a CFA study the ‘effects on the costs and revenues’ of any affected agency. The remaining City obviously would be an affected agency. Also, AB 62 in the 1997 California Legislative Session paved the way for the feasibility of special reorganizations. The history of that measure reflects the intention that the remaining City not be subjected to financial harm. The most obvious form of financial harm would present itself in the need to raise revenues and/or cut service levels for the residents and businesses in the remaining City.

The City identifies five concerns to support its conclusion. These concerns are:

**City Concern 1:** The CFA does not analyze the impacts to the City after the transition period or service contract ends.

**City Concern 2:** The CFA does not address transition costs.

**City Concern 3:** The CFA does not contain a traditional cash-flow analysis.

**City Concern 4:** The CFA incorrectly allocated debt between the City and the new Valley city.

**City Concern 5:** The CFA fails to examine the cumulative effect of the various fiscal conditions to which the new Valley city will be subjected.

## **ANALYSIS OF UNDERLYING CONCERNS CITED BY THE CITY AS ITS BASIS FOR CITY ISSUE 2**

### **City Concern 1**

The City expresses its first concern as follows:

The CFA fails to analyze the fiscal, service level, and employee impacts to be incurred by the remaining City after the termination of the transition period or service contract. CFA at 9-10. The CFA does discuss the possibility of a decrease in certain federal and state funding in the remaining City. See CFA at 10. But the larger consequences of the closure of the revenue stream from the Valley are not examined.

### **State Controller's Office Analysis and Response to City**

**Concern 1:** The State Controller's Office concludes that the CFA is not required to address the impact to the City beyond the period covered by the CFA. Currently, the CFA assumes that all services would continue to be provided by the City during this period.

The City is addressing what it has referred to as "stranded costs." The City believes stranded costs are centralized, non-divisible costs that would remain with the City at the end of the transition period or end of the service contract period so the City can maintain the same service levels.

*Government Code* Section 56800 (a) requires that the CFA review and document "[t]he costs to the proposed city of providing public services and facilities during the three fiscal years following incorporation...." Section 56800 (b) requires the CFA to also document and review "[t]he revenues of the proposed city during the three fiscal years following incorporation."

While the CFA assumes a transition period of up to three years, the supplemental report to the CFA assumes a transition period of 18 months followed by a service contract of 18 months. During the total 36 months, the CFA assumes that all services would be provided by the City. In addition, the CFA assumes that the services would be paid for by the new Valley city. Finally, the CFA assumes that: "... the services provided and the cost of those services will be the same during the transition period and under contract, although the cities may ultimately negotiate for the provision of different services or levels of service and different

payment terms or for the transfer of some or all service responsibilities to the new Valley City.”

Given the size of the new Valley city, these would seem to be appropriate assumptions to arrive at an accurate estimate of the impact to both the City and the new Valley city during the period covered by the CFA.

## **City Concern 2**

The City expresses its second concern as follows:

The CFA does not take into account a comprehensive list of transition costs (the costs the City incurs implementing the special reorganization). CFA at 38-41; App I at 1-3; CAO Report on IFA, June 2001; CAO spreadsheet on transition costs.

## **State Controller’s Office Analysis and Response to City**

**Concern 2:** This was addressed as part of the State Controller’s Office response to City ISSUE 1, City Concern 4.

## **City Concern 3**

The City expresses its third concern as follows:

The CFA proposes that the new city would be required to make payment to the City by paying a portion of its revenues no longer collected by the City following incorporation. The new city will have a negative cash flow during its first year attributable to lags in revenue receipts. The CFA does not recognize the negative cash flow and mitigate the risk that the City would face of non-payment under these circumstances. CFA App I at 2-3; RJ Rudden Report, 2001.

## **State Controller’s Office Analysis and Response to City**

**Concern 3:** The State Controller’s Office concludes that the *Government Code* does not require that the CFA contain a cash flow analysis. Therefore, the Rudden report, which was commissioned by the City, is not relevant.

In addition, while the CFA does not include a traditional cash flow analysis that matches monthly cash revenue receipts with monthly cash expenditure payments, the State Controller’s Office has

determined that it does provide information that would be substantially the same as if a traditional cash flow analysis had been performed for the new Valley city. In addition, it includes three assumptions that ensure that cash flow problems of the proposed new Valley city do not adversely affect the City.

First, the CFA assumes that the City would “...collect all Valley revenues that are not paid directly to the new city, and would retain all amounts for payment of City provided contractual services and a mitigation.” Second, it assumes that any revenues paid directly to the new Valley city would be immediately paid to the City to ensure that the City can meet its ongoing operating expenses. Finally, the CFA notes that some revenues are received monthly, others quarterly, and some, such as property taxes, sporadically, and concludes that receipt of property tax revenues may not match the expenditure requirements of the City.

#### **City Concern 4**

The City expressed its fourth concern as follows:

Some of the formulae used in the CFA for allocation of debt change the existing debt burden. This change is unfair because the debt was incurred in reliance on revenue streams that included those coming from the Valley. A result of this change is a reduction in the level of debt service to be received from the Valley by the remaining City. CFA App II at 173-77; CFA E Tables.

#### **State Controller’s Office Analysis and Response to City**

**Concern 4:** The State Controller’s Office concludes that the CFA’s methodology of allocating bond debt based upon the number of employees does not produce an accurate and reliable result. It understates costs associated with bond debt by \$4.0 million per year. This would virtually eliminate the projected new Valley city general fund reserves.

The CFA notes that the City does not retain records that identify the location of many of the assets financed with lease obligation bonds and certificates of participation. In instances where the City was able to identify the location of the asset financed with lease obligation bonds and certificates of participation, the debt was allocated based upon asset location. In instances where the City

could not identify the location of the asset, LAFCO based its allocation on the number of employees assumed to serve the Valley as a percentage of the total City employees.

In other documentation provided by the City, the City stated that debt to be repaid with general fund monies should be allocated based upon the loss of general fund monies by the City. Under this position, using the percentage of general fund revenue allocated to the new Valley city, the new Valley city would be responsible for approximately 30.77% of the general fund debt. The City's recommended methodology would appear to produce a more accurate result.

The CFA estimated the Judgment Obligation Bonds Debt Service Fund portion payable from the new Valley city for FY 2000-01, based upon a 26.88% share, to be \$9.5 million. Under the City proposal this share would increase to \$10.7 million, an increase of \$1.2 million. Similarly, General City Purposes debt service would increase from \$21.4 to \$24.2 million, an increase of \$2.8 million.

### **City Concern 5**

The City expressed its fifth concern as follows:

The CFA fails to examine the cumulative effect of fiscal conditions being planned for the new city. The low reserve when coupled with the substantial payments that are to be made to the remaining City for debt service, mitigation payment, transition costs, and service contracts collectively will place the new city under tremendous fiscal pressure. With the remaining City so dependent upon these payments, the remaining City similarly will be put at substantial fiscal risk. This overall circumstance is not examined by the CFA. CFA at 36; App I at 12-15; CAO Report on IFA, June 2001; Moody's Investor Service, 2001; RJ Rudden Report, 2001; CAO Report on Cash Flow Evaluation, December 2001; CAO spreadsheets on debt distribution.

### **State Controller's Office Analysis and Response to City**

**Concern 5:** This appears to be a summation of issues that are analyzed elsewhere in this report. These analyses indicate that some elements used in computing the level of reserves may be in

error, some significantly and others less so. If the CFA is revised to address these errors, it is expected that the new Valley city will have a lower level of reserves.

In addition, as previously noted, future reserves are contingent on many unknown financial variables. The State Controller's Office research indicates that reserve levels tend to fluctuate from year to year and, therefore, the portion of the CFA that indicates that the reserves for the new Valley city will increase is unreliable.

**State Controller's Office Conclusion to City ISSUE 2:**

**The State Controller's Office concludes that the CFA adequately considers the financial impact to the remaining City. However, the review also identified a potential adverse effect on the projected reserve level for the new Valley city, resulting from a change in the bonded debt allocation ratio.**

**CITY ISSUE 3**      The City raised the following issue in its request to LAFCO:

**“Does the CFA adequately address the fiscal impact of the proposal on other affected agencies?”**

The City states the following:

The fiscal impact on other affected agencies should be analyzed in the CFA, as required by Cortese-Knox.

The City identified five concerns to support its position that fiscal impacts to local agencies were not addressed. These concerns are:

**City Concern 1:** The CFA did not account for the loss of the Vehicle License Fee revenues on other cities in California.

**City Concern 2:** The CFA did not account for the loss of documentary transfer tax on the City and the County of Los Angeles.

**City Concern 3:** The CFA did not consider the impact that a shift in Older Americans Act funds from the City will have on the County of Los Angeles.

**City Concern 4:** The CFA did not address the impact of the potential incorporation on the County of Los Angeles for the provision of fire and police services in the unincorporated area of Universal City.

**City Concern 5:** The CFA did not consider the impact that a change in the provision of fire service would have on the City of San Fernando.

### **ANALYSIS OF UNDERLYING CONCERNS CITED BY THE CITY AS ITS BASIS FOR CITY ISSUE 3**

#### **City Concern 1**

The City expressed its first concern as follows:

The CFA does not appear to account for the impact on other cities throughout California related to the decrease in receipts of Vehicle Licensing Fees (VLF) that would result from the redistribution of these funds to a newly incorporated city. State law provides an increased level of VLF revenues for newly incorporated cities. There is finite amount of VLF revenues statewide. Therefore, an increase for one means a decrease for others. CFA at 33.

#### **State Controller's Office Analysis and Response to City**

**Concern 1:** The State Controller's Office concludes that the CFA is not required to address the effect on any city other than Los Angeles. Moreover, the Vehicle License Fee revenue impact on the City should be minimal.

The addition of any new city in the State of California can, and usually will, impact the distribution of vehicle license fees to all other cities in California. However, the *Government Code* only requires that the impact of the formation of the new Valley city be assessed and addressed for affected local agencies, which excludes any city but Los Angeles.

Revenue from the state Vehicle License Fee will become available to the new Valley city upon the effective date of incorporation. These revenues are usually allocated to cities based upon population. However, for newly incorporated cities, a "proxy" population is used for the first seven years of incorporation. *Revenue and Taxation Code* Section 11005.3(b)(1), allows a newly

incorporated city to assume a “population” of the larger of (1) three times the number of registered voters or (2) actual population. In most instances, three times the number of registered voters will result in a larger “population” for the new city. When this happens, there is a minor fiscal impact on the City of Los Angeles, which is not identified in the CFA but which is also not required to be mitigated.

## **City Concern 2**

The City expressed its second concern as follows:

The CFA also does not appear to account for the decrease in revenues caused by the loss of a portion of documentary transfer tax which impacts both the City and County of Los Angeles. CFA at 28; App I at 20.

### **State Controller’s Office Analysis and Response to City**

**Concern 2:** This concern was previously addressed under ISSUE 1, City Concern 5.

## **City Concern 3**

The City expressed its third concern as follows:

The CFA does not consider the impact on the County of Los Angeles of a shift of Older Americans Act funds from the City for administration of aging programs in the secession area previously administered by the City. CFA at 31; App I at 21.

### **State Controller’s Office Analysis and Response to City**

**Concern 3:** The State Controller’s Office concludes that the County will be required to increase its matching funds for this program by nearly \$80,000 annually. However, this will not require any mitigation. In addition, the CFA does not reflect that the City will have an equal reduction in its matching requirements of the same amount.

The Older Americans Act funds services for senior citizens. Typically, counties administer these funds and initially the County of Los Angeles administered this program within the City. In 1975, the City received designation as an Area Agency on Aging and began administering its own program. The new Valley city will not

have the designation as an Area Agency on Aging. Therefore, the County of Los Angeles will be responsible for programming the Older Americans Act funds associated with the new Valley city. The County of Los Angeles already administers this program for all cities in the County with the exception of Los Angeles.

The Older Americans Act program is a federal grant program. This grant requires local matching funds equal to 25% of the grant amount to cover administration. The City estimates that \$300,000 of its total \$1.3 million Older Americans Act grant will shift to the County after secession. The County will therefore need to provide \$79,770 in matching funds to cover program administration, which has not been considered in the CFA.

#### **City Concern 4**

The City expressed its fourth concern as follows:

The CFA does not consider the potential impact on the County of Los Angeles concerning that portion of Universal City located in unincorporated territory that would result from a change in responsibility for fire and law enforcement services once a transfer of service from the City of Los Angeles to a proposed new city occurs. That area attracts a substantial number of tourists and other visitors.

#### **State Controller's Office Analysis and Response to City**

**Concern 4:** The State Controller's Office concludes that there is no substantive impact on the County of Los Angeles regarding the responsibility for fire and law enforcement services in the Universal City area as a result of the creation of the proposed new Valley city.

The City and the County, through a memorandum of understanding (MOU), have agreed to exchange fire suppression resources in specified areas, including the Universal City area. In the agreement, the City has agreed to respond with one engine company to the portion of Universal City as designated on Map 9 of the MOU. The County has agreed to respond with one engine company to the portion of Universal City as designated on Map 34 of the MOU. In addition, the City has agreed to respond with additional forces to the area designated on Map 9 in response to second and third fire alarms. Finally, the City has agreed to provide emergency medical services to the portion of Universal City designated on Map 1 of the MOU. The MOU does not state that fees shall be paid by either agency for services rendered.

However, the MOU does state that “substantial reductions of services by either Department shall be cause for reconsideration of this MOU.”

The CFA assumes that the City would provide fire services to the new Valley city for the period covered by the CFA. This will have no effect on the current fire services MOU that the City has with the County which affects an area outside of the new city.

### **City Concern 5**

The City expressed its fifth concern as follows:

The CFA does not consider the potential impact on the City of San Fernando of a change in responsibility for fire services once a transfer of service from the City of Los Angeles to a proposed new city occurs. By contract, the City of Los Angeles currently provides fire services to the City of San Fernando.

### **State Controller’s Office Analysis and Response to City**

**Concern 5:** The State Controller’s Office concludes that the CFA is not required to consider the impact on the City of San Fernando.

The City of San Fernando does not meet the definition of an affected local agency. *Government Code* Section 56014 defines an affected local agency as “any agency which contains, or would contain, or whose sphere of influence contains, any territory within any proposal or study to reviewed by the commission.” Therefore, the CFA is not required to consider any potential impacts to it.

### **State Controller’s Office Conclusion to City ISSUE 3:**

**The State Controller’s Office concludes that the CFA did not address all fiscal impacts of the proposed new Valley city on affected agencies other than the City of Los Angeles. However, in some cases it was not required to do so, and in other instances no mitigation was required.**

**CITY ISSUE 4**      The City raised the following issue in its request to LAFCO:

**“Does the CFA establish an accurate service level for the proposed new city (a) equal to the current level and (b) based upon a base year budget of the City of Los Angeles?”**

The City states the following:

Accuracy of the service level and associated cost is essential to a realistic assessment of the nature of the government being proposed. This information is also required to estimate a baseline for a transition year and for future contract negotiations.

The City identifies only one concern as follows:

Insufficient detail is provided in the CFA to support the service level presented. Specific positions, classifications, and costs are not detailed enough in their allocation to support the apportionment contained in the CFA. CFA App II. Hence, it is not known whether the service level and associated costs have a fiscally sound foundation.

**State Controller's Office Review and Analysis of City ISSUE 4:**

The State Controller's Office concludes that the methodology used in the CFA to allocate service levels is reasonable and accurate.

The CFA determined service levels attributable to the Valley area through meetings with City administration and department managers and a review of the City budget and departmental organization charts for fiscal year 2000-01. The CFA determined the staffing levels for both direct and indirect services based primarily upon the approved positions on the organization charts, reconciled to the approved positions in the budget.

The CFA determined direct service costs by considering the staffing physically located in or directly assigned to Valley locations. Indirect services staff performs support and headquarters functions that are not easily or physically associated with a geographic area. The CFA methodology used an allocation process to calculate the Valley's proportion. The CFA developed this proportion based on the ratio of personnel in the Valley for a service function to personnel Citywide for the function. This proportion yields the Valley's indirect staffing (and budget) level when multiplied by the City's total indirect staffing level (and budget) for that function. The CFA used this process to assign support staffing levels (and budget) from all City departments. This appears to be an appropriate methodology.

**State Controller's Office Conclusion to City ISSUE 4:**

**The State Controller's Office has concluded that the methodology used in the CFA to allocate service level is reasonable and accurate. The costs for direct and indirect services are based primarily upon the approved positions on the City's organization charts, reconciled to the approved positions in the City's budget.**

**CITY ISSUE 5**     The City raised the following issue in its request to LAFCO:

**“Did the CFA's calculation of revenue neutrality reflect the cost impacts the City will realize at the end of the transition or service contract period?  
CFA at 37; App. I at 10-11.”**

The City provided only one concern as follows:

The CFA's calculation of revenue neutrality does not reflect the cost impacts to the City after the end of the transition or service contract period. The CFA evidently pegged revenue neutrality at \$65.8 million by deducting the City's budgeted expenditures for services that would be paid by the Valley city through a service contract with the City (i.e., the cost of purchased services) from revenues that would accrue to a Valley city (i.e., revenues lost to the City). The City has voiced objection to LAFCO concerning this approach on several previous occasions. See, e.g., letter of June 7, 2000 from Fredrick N. Merkin of the City Attorney's Office to Assistant County Counsel John F. Krattli. The City believes that the correct approach required an assessment of the savings the City would enjoy by not having to service the Valley. In the City's view, these cost savings should then be deducted from lost revenue to yield the mitigation payment (or other lawful form of mitigation) required by the revenue neutrality law. These savings will be much less than the projected cost of purchased services, because the City will need to maintain many centralized and non-divisible services (resulting in 'stranded costs') in order to continue the same service level of service to the residents of the remaining City post-secession. While the question of what methodology Cortese-Knox requires to calculate

revenue neutrality is a legal one to be resolved, if at all, in the courts, this request asks only that the Controller review and confirm that the CFA's calculation of revenue neutrality did not take these costs into account.

The CFA noted the City's contention that certain municipal functions are not divisible, that secession would not result in a reduced workload for certain City personnel, and that new personnel would have to be hired to maintain the same level of service for the remaining City. The CFA observed that with a reduction in the City's population of over 36% (more than 1.3 million people), with certain noted exceptions 'the remaining workload confronting City departments would decrease significantly across the range of municipal operations.' According to the CFA, to make its case, the City would need to produce data demonstrating the absence of workload reduction. The CFA went on to state that since these data had not been supplied, 'it is difficult to substantiate the argument that the City's workload would not decrease.' Yet, in the end the CFA asserts that it avoids the problem raised by the City because of the service contract model studied. According to that approach, few, if any, City employees would be transferred to the Valley city, as the City would continue to render virtually all services to the Valley. Hence, the City would not be required to hire additional personnel. CFA App I at 10-22; App II Cost of Purchase Services; CFA E Tables. The result of such an approach is to ignore the substantial fiscal impacts that the City of Los Angeles will realize at the end of the transition period or termination of any service contracts, when the City is no longer compensated for centralized and non-divisible costs through contract payments from the Valley, and these costs become stranded. Absent mitigation, the proposal under study would push the remaining City of a financial cliff at this point. The CFA approach also fails to address the need for that impact to be mitigated by a revenue neutrality payment (or other lawful form of mitigation) in order to preserve existing service levels in the remaining City.

The Controller is requested to confirm only that: the description above accurately reflects how the CFA went about calculating revenue neutrality. Whether this was the correct methodology is a different question altogether. Whatever methodology is to be applied constitutes a derivative of the interpretation of the revenue neutrality law. Disputes over that interpretation must be resolved, if they are to be resolved, in the courts. This issue's low placement on the City's priority list should not be seen as a reflection of the City's belief in the relative unimportance of the issue. On the contrary – the revenue neutrality methodology to be applied here represents an issue of prime importance to the City. The City has placed this issue here because it clearly turns on the interpretation of a statute.

**State Controller's Office Review and Analysis of City ISSUE 5:**

The State Controller's Office concludes that the CFA has accurately described how revenue neutrality was addressed in the CFA and that mitigation does not include stranded costs.

However, *Government Code* Section 56815 validates the CFA's methodology to base mitigation payments solely on the difference between current revenue and current expenditures. Therefore, the CFA is not required to reflect cost impacts the City may realize at the end of the period covered by the CFA.

**State Controller's Office Conclusion to City ISSUE 5:**

**The State Controller's Office concludes that the City of Los Angeles has accurately described how revenue neutrality was addressed in the CFA and that mitigation does not include stranded costs.**

State Controller  
**Kathleen Connell**

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